MOTION FILED
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NO. 82-106

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1981

GLEN CORPORATION, et al.,
Petitioners,

v.

O. C. ASSOCIATES, et al.,
Respondents.

# MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF AND AMICUS CURIAE BRIEF IN SUPPORT OF PETITION TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF AND AMICUS CURIAE BRIEF

Continental Mortgage Investors, Debtor (hereinafter "CMI") hereby respectfully moves for leave to file the attached amicus curiae brief in this case. The consent of the attorneys for the petitioners has been obtained. The consent of the attorneys for the respondents was requested but not received.

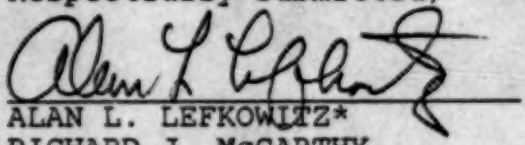
The interest of CMI in this case arises from the fact that, directly in re-

sponse to the decision of the United States Court of Appeals for the First Circuit in the instant case mandating payment to debentureholders of post-petition interest on unpaid interest as a matter of federal law, the United States District Court for the District of Massachusetts, presently conducting the CMI reorganization proceeding, reversed its prior finding and excluded 27,000 shareholders from all participation in the reorganized CMI.

The amicus curiae brief, which CMI hereby requests permission to file, illustrates, through the plight of the CMI shareholders, the immediate adverse impact of the decision of the Court of Appeals on the proper application of the absolute priority rule. In addition, the amicus curiae brief argues that the instant case will frustrate the implementation of two major reforms effected by the new Bankruptcy Code. Neither of these reforms is

discussed in the petition.

Respectfully submitted,



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STATEMENT OF
INTEREST OF CONTINENTAL
MORTGAGE INVESTORS, DEBTOR

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This amicus curiae brief is filed pursuant to Supreme Court Rule 36.1. by Continental Mortgage Investors, Debtor (hereinafter, sometimes "CMI" or "Debtor"), in behalf of its approximately 27,000 public shareholders owning more than 20,000,000 outstanding shares, in support of the certiorari petition of Glen Corporation, et al. The petition seeks review of a United States Court of Appeals for the

First Circuit decision which discovered, sua sponte, a federal non-contractual right of debentureholders to post-petition interest on unpaid interest even though such interest is barred by applicable state law (New York). Directly in response to that decision, the United States District Court for the District of Massachusetts, conducting the CMI reorganization proceeding, reversed its prior finding that Debtor's shareholders were entitled to a 7% equity in a reorganized CMI and ordered the Chapter X Trustee to submit a new plan by September 20, 1982 which will exclude all such shareholder participation. If the Court of Appeals' decision is not reversed or limited, Debtor's 27,000 public shareholders will have lost their long struggle to participate in CMI's reorganization.

Debtor is a Massachusetts business trust with transferable shares which

has been in reorganization proceedings under the Bankruptcy Act of 1898 since March 8, 1976. With book value assets of $750,000,000 at the date of the filing of its Chapter XI petition, Debtor was then the third largest reorganization proceeding in the history of the United States. Its assets consisted of over 250 separate real estate projects located principally in the so-called "sun-belt" of the continental United States and in Puerto Rico and Hawaii. Its 20,000,000 outstanding shares had been actively traded on the New York Stock Exchange.

On May 1, 1979, the United States District Court for the District of Massachusetts (the "CMI reorganization court") ordered Debtor into Chapter X and revoked the earlier reference to the Bankruptcy Judge before whom the case had been pending

and who had erroneously adjudicated Debtor bankrupt.[1] Although two Chapter X trustees then were appointed, Debtor's own trustees, duly elected by its shareholders in 1975, continued to function as a board during the Chapter X proceedings, primarily in behalf of its shareholders. No shareholder committee was ever organized.

The efforts of Debtor contributed significantly to a compromise settlement (the "Compromise"), formally approved by the CMI reorganization court in May 1980, whereby Debtor exchanged most of its properties for cancellation of more than $500,000,000 of unsecured senior creditor claims. Debtor was then left with $12,000,000 cash, valuable property in

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1 In Re Continental Mortgage Investors, 528 F.2d 872 (1st Cir. 1978).

Hawaii, and an asserted net operating loss of at least $140,000,000. The claims of its junior creditors, unsecured convertible note holders and debentureholders, aggregated $45,882,000 principal and pre-petition interest, and $17,059,000 of post-petition interest. On December 18, 1981,[2] after extensive hearings, the CMI reorganization court found Debtor's reorganization value to be $67.8 million and specifically held that

> the shareholders will participate in this reorganization only to the extent that the reorganization value of the estate exceeds the claims of creditors.

App. A, at 10a - 11a.

The CMI reorganization court recognized the equitable rights of share-

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[2] Unreported Memorandum Opinion which appears in Appendix A hereto.

holders to participate in a reorganized company, and so provided by (i) limiting post-petition interest on notes and debentures to pre-petition contract rates and (ii) specifically disallowing any interest on interest. All of the CMI convertible notes and debentures provide that the rights of the holders thereof are governed by the laws of the State of New York.

Translated into numbers, the decision meant that Debtor's shareholders were to have an equity in excess of $4 million (being the excess of reorganization value of $67,800,000 over principal and interest of $62,900,000 owed to note and debentureholders) or just over 7% of the reorganized company. The first reorganization plan filed by the Chapter X Trustee, which was supported by the Debtor, specifically recognized this shareholder equity.

The Trustee's plan was also supported by at least a majority in amount of all debentureholders who thereby acknowledged existing shareholder equity.

While the CMI reorganization court rejected all of the proposed plans because none adequately provided for a "cash-out" option for those debentureholders who didn't wish to participate in the reorganized company, it continued to recognize shareholder participation under any plan, saying

> the shareholders' share [is to be] calculated on the basis of the excess of the value which I have placed on the estate over debts, post-petition interest to be limited to the pre-default rate, without interest on interest.

App. A, at 20a-21a.

New plans were submitted and additional hearings thereon were conducted

during April 1982. On April 30, the United States Court of Appeals for the First Circuit issued its opinion. On July 15,[3] the CMI reorganization court, finding that it was bound by a decision "in a case [i.e., the instant case] in pertinent respects on all fours with this one", declared that CMI debentureholders "are entitled to interest on unpaid post-petition interest as a matter of federal law", App. B, at 12b, and "excluded" Debtor's shareholders from the reorganized company "since debentureholders' claims exceed the reorganization value of CMI". App. B, at 14b.

REASONS FOR GRANTING THE WRIT

Debtor adopts and supports the arguments made by petitioners in their

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3 Unreported Memorandum Opinion which appears in Appendix B hereto.

brief to this Court. Debtor contends, in addition, that the decision of the United States Court of Appeals for the First Circuit should be reviewed because of (i) its direct effect upon one of the fundamental legal principles of reorganization carefully developed by this Court, namely, the rule of absolute priority, and (ii) it will frustrate implementation of two major reforms of the new Bankruptcy Code.

## I. THE COURT OF APPEALS' DECISION DIRECTLY INTERFERES WITH PROPER APPLICATION OF THE ABSOLUTE PRIORITY RULE.

The absolute priority rule is derived from the requirement of Section 221(2) of the former Bankruptcy Act[4] (the

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[4] 11 U.S.C. §621(2). The Bankruptcy Act was repealed, effective October 1, 1979, but cases commenced prior thereto remain subject to its provisions.

"Act") that the "judge shall confirm a plan if satisfied that ... (2) the plan is fair and equitable..." The fair and equitable language has been carried over into Section 1129(b)(1) of the new Bankruptcy Code[5] (the "Code"). The Code section permits the court to "cram down" a plan over objections of creditors if, among other things,

> the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

The legislative history of the Code makes clear that the absolute priority rule under the Act continues to be operative under the Code.

> The general principle of the subsection [i.e., §1129(b)(1)] permits confirmation notwithstanding nonacceptance by an impaired

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5 The provisions of the Bankruptcy Code are applicable to all cases commenced on and after October 1, 1979.

> class if that class and all below it in priority are treated according to the absolute priority rule.

H. R. REP. No. 595, 95th Cong., 1st Sess. 413 (1977).

Since Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510 (1941) this Court has continually recognized that the absolute priority rule provides a reorganization court with flexibility to structure a fair and equitable plan by assigning value to new securities other than by precise financial computations.

> But whether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on the facts and requirements of each case. So long as new securities offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the Court.

Consolidated Rock Products Co., supra, at 529-30 [emphasis added].

In Group of Institutional Investors v. Chicago, M., St., P. & P.R. Co., 318 U.S. 523, 565 (1943) this Court reiterated the flexibility of the rule:

> It is sufficient that each security holder in the order of his priority receive from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered.

The decision of the Court of Appeals, however, has compelled the CMI reorganization court to abandon the flexibility of the absolute priority rule and thereby forced it to extinguish equities which it had determined in favor of Debtor's shareholders. The decision is understandable in view of the confusion created by the Court of Appeals' acknowledged refusal to relate its decision to the rule of absolute priority. In that part of its opinion discussing the new federal noncontractual right to post-petition interest

on interest, the Court of Appeals specifically refers to the established priority rules of Chapter X but fails to explain how post-petition interest on interest is to be accomodated within them.

> We need not decide whether with respect to such a non-contractual right it would be fair and equitable and within the district court's power ... to require a straight debentureholder to take a financially equivalent substitute in exchange for his right to post-petition interest on interest, against the will of the debentureholder and solely to benefit stockholders. Nor need we consider whether to compel such a deprivation of the non-contractual right to interest on interest violates the "absolute priority" rule. See 6 Collier on Bankruptcy ¶9.08 at 1583 (14th ed., 1978).

Petitioner's App. Ex. A, at 16a.

To permit unsecured debentureholders to receive post-petition interest on interest for which they never bargained and which is illegal under state law so as to

exclude shareholders from a reorganized company to which a court has found them to be equitably entitled is a perversion of the rule of absolute priority, whether under the Act or the Code. Debentureholders, as in the case of CMI, even without post-petition interest, often receive greater value as a result of acceleration of principal obligations in bankruptcy than the present investment value of their debentures.[6] In utility cases, this Court has held that senior security holders should be compensated for the "investment value" of their contracts in the continuing enterprize, and not for rights arising on default. See, Niagara Hudson Corp. v. Levintritt, 340 U.S. 336 (1951); SEC v.

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6 The CMI notes and debentures, in the absence of default, would have come due in 1989 and 1990.

Central Illinois Securities Corp., 338 U.S. 96 (1949); Otis Co. v. SEC, 323 U.S. 624 (1945).

The rule of absolute priority requires no more than that the securities distributed to the CMI debentureholders equal, but certainly not exceed, the quality of the securities surrendered under the reorganization plan. See, Billyou, Priority Rights of Security Holders in Bankruptcy Reorganization, 67 HARV. L. REV. 553 (1954); Blum, Full Priority and Full Compensation in Corporate Reorganization, 25 U. CHI. L. REV. 417 (1958). Section 1129 (b)(2) of the Bankruptcy Code codifies the rule.[7] By awarding post-petition interest

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[7] Section 1129(b)(1) provides, in part, that "the court...shall confirm the plan...if the plan does not discriminate unfairly, and is fair and equitable with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."

on interest debentureholders are likely to receive a windfall occasioned solely by bankruptcy. See, Bonbright and Bergman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization, 28 COLUM. L. REV. 127 (1928).

We need not speculate as to whether the right to obtain such a windfall has now been established for future cases. It is about to happen to CMI debentureholders as a direct result of the Court of Appeals' decision. The CMI reorganization court regards that decision as "a flat rule of law" which does not permit it to take into account some "equities in favor of shareholders", as does the rule of absolute priority. App. B, at 16b. Moreover, under the Court of Appeals' "financial equivalence" test, the CMI reorganization court believes it must be able "to quantify"

non-monetary benefits accruing to debentureholders as a result of the Compromise with senior creditors in order to find that such benefits compensate debentureholders for lost interest on post-petition interest. This the CMI reorganization court is unable to do. App. B, at 15b. Nor, we suggest, could any other court make such a financial determination with any reasonable degree of certainty.

## II. THE COURT OF APPEALS' DECISION WILL FRUSTRATE IMPLEMENTATION OF TWO MAJOR REFORMS EFFECTED BY THE NEW CODE.

The Court of Appeals' refusal to deal with the absolute priority rule will cause parties to resort frequently to the complex valuation procedures of Section 1129(b)(1) and (2) of the Code and require obtaining of formal consents to Chapter 11 plans, which is precisely what the Code

draftsmen sought to avoid. One major Code reform is to expedite confirmation of Chapter 11 plans by avoiding the lengthy and expensive valuation hearings which were required prior to formulation of a Chapter X plan under the old Act. Thus, if CMI had not conveyed most of its properties in cancellation of its senior debt, its reorganization could have involved valuations of 250 separate properties by the reorganization court. Under the Code, however, no Chapter 11 valuation hearing is required unless there is formal objection by a class of creditors or the rights of any class are impaired and such class objects.

Another major Code reform is to reduce the expensive need for obtaining formal consents from each class of claim or interest to a plan. Hence, a court is required to confirm a plan if it meets certain basic

requirements set forth in Section 1129(a) and

> with respect to each class -
>
> (A) such class has accepted the plan; or
> (B) such class is not impaired under the plan.

Section 1129(a)(8).

If a class is unimpaired, its acceptance of the plan is assumed.[8]

Impairment of a class of claims or interests occurs unless,

> with respect to each claim or interest of such class, the plan (1) leaves unaltered the legal, equitable and contractual rights to which such claim or interest entitles the holder of such claim or interest....

Section 1124.

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8 Section 1126(f) provides that: "Notwithstanding any other provision of this section, a class that is not impaired under a plan is deemed to have accepted the plan, and solicitation of acceptance with respect to such class from the holders of claims or interest of such class is not required."

As a result of the Court of Appeals' decision, if a Chapter 11 plan fails to recognize post-petition interest on interest because it is illegal under applicable state law, debtholders will deem their rights impaired under Section 1124(1) and will be able to force valuation hearings to obtain what in many instances will result in a windfall for them. If, on the other hand, a Chapter 11 plan awards such interest, creditors junior to debtholders and stockholders are likely to deem their contractual and equitable rights impaired by the windfall and be able to force valuation hearings. In either event, the Code provisions for expeditious confirmation of reorganization plans will have been lost and the increased expense to the estate of valuation hearings and the possible need

for obtaining formal consents will be significant.[9]

Had the Court of Appeals' decision focused upon the relationship between the rule of absolute priority and the federal non-contractual right to post-petition interest on interest, the dilemma might possibly have been avoided. A reorganization court might have been furnished with a rule as to when and to what extent, if any, a windfall from post-petition interest on interest could, consistent with the rule of absolute priority, be permitted without interfering with the equitable interests of junior creditors and stockholders. Standing as it does, the decision deprives parties of their contractual or equitable rights, produces windfalls for creditors,

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9 See, 5 Collier on Bankruptcy ¶1124.03 at 1124-11 (15th ed. 1979).

and increases the expense and burden of administration of estates.

## CONCLUSION

For the reasons stated above, certiorari should be granted to review the judgment of the United States Court of Appeals for the First Circuit.

Respectfully submitted,

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August 16, 1982

APPENDIX A

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

| | | |
|---|---|---|
| In Re | * | In Proceedings |
| CONTINENTAL MORTGAGE INVESTORS, | * | for the Reorganization |
| | * | of a Corporation |
| Debtor | * | |
| | * | No. 76-593-S |

MEMORANDUM AND ORDER ON
PROPOSED REORGANIZATION PLANS

December 18, 1981

SKINNER, D.J.

This former Real Estate Investment Trust ("REIT") petitioned for reorganization under Chapter XI in March of 1976. The petition was referred to a bankruptcy judge, before whom the various creditors contended without result until May 1, 1979, when I revoked the reference and ordered the company into Chapter X reorganization as an alternative to liquidation. In May

of 1980, this court approved a compromise between the senior debtholders, the subordinated debtholders (hereinafter the debenture holders), and the Chapter X Trustees. As a result, the senior debtor received all of the debtor's real estate holdings except Hawaii Loa Ridge ("the Ridge"). Various adjustments of cash and liabilities were made (and have been readjusted since) which in a general way leave the debtor (in addition to the Ridge) about $12 million in cash, claims against some of its former officers, some liabilities not related to assets conveyed to the senior creditors, and an asserted net operating loss carryforward of $140 million. The claims of the debenture holders total $45,882,000 principal and pre-petition interest, with an asserted claim of $17,059,000 in post-petition interest[1] to September 30, 1981. The

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[1] At pre-default rates, and without interest on interest.

debenture holders are represented by two groups, Committee A and Committee B. There are approximately $3 million of other pre-petition and administrative claims.

There is presently outstanding an offer to the trustee from Nu-West Corporation to buy Hawaii Loa Ridge for $33 million cash.

A. The Plans.

Four plans have been filed:

1. The Trustee's plan provides for a single class of stock in which the shareholders participate at 7.5% with an option to purchase one additional share for each share distributed at twice the per share reorganization value. The scenario implicit in the Trustee's plan calls for the development and sale of Hawaii Loa Ridge with profits therefrom to be tax-sheltered by the net operating loss carry-forward (the NOL). The cash is then to be rein-

vested in a new business enterprise, probably unrelated to real estate investment.

2. John Hancock Mutual Life Insurance Company, the holder of senior debt and debentures has filed a plan which differs from the Trustee's in the following respects: Debenture holders shall have the option to choose between interest bearing notes and shares having a reorganization value of 115% of their allowed claims, provided that the amount of notes does not exceed $30 million and provided further that interest shall be payable only to the extent of income; shareholders shall receive one share in the new corporation for each share of CMI; and development and sale of Hawaii Loa Ridge must be completed by June 30, 1988.

3. Mary Mayer, a stockholder, has filed a plan, the salient distinguishable feature of which is that it calls for the shareholders to participate with the deben-

ture holders on a 50-50 basis.

4. Committee B has filed a plan calling for the immediate disposition of Hawaii Loa Ridge and the liquidation of CMI. By their calculation this would permit debenture holders to receive 105% of their principal. Shareholders would receive nothing. Committee has also filed a motion for an order directing the Trustee to accept the offer of Nu-West to buy Hawaii Loa Ridge for $33 million.

Committee A and the Eisenberg-Whitman group of debenture holders support the Trustee's plan.

The debtor generally supports the Trustee's plan but urges greater participation for the shareholders.

B. Plans Worthy of Consideration (Bankruptcy Act, §169, Rule 10-303).

I find all of the plans worthy of consideration except the plan offered by Mrs.

Mayer, which so grievously distorts the absolute priority rule as to be unworthy of consideration, and the John Hancock Plan, discussed below.

In any case, I have been informed by the Securities and Exchange Commission that its staff will not review any plans or advise me with reference to them because of budgetary restrictions. Accordingly, I shall proceed directly to consideration of their fairness, equity and feasibility, Bankruptcy Act, §216.

C. Consideration of the John Hancock Plan.

The John Hancock Plan calls for a substantial part of the recapitalization of the reorganized company to be in the form of debt, up to $30 million, albeit with relatively non-onerous interest provisions. The problem with it is that not a single one of the financial experts who testified in the hearings supported such a plan as

being in the best interest of the estate. All were unanimous in condemning such a plan as imposing an unnecessary burden on the reorganized company. Accordingly, I find that the proposed John Hancock plan is not worthy of consideration, and by extension not fair, equitable and feasible.

D. Consideration of Shareholders' Rights.

Ordinarily a reorganization plan must recognize the absolute priorities of different classes of claimants. The shareholders are at the bottom of the ladder, and participate only to the extent that available assets exceed the provable claims of creditors.

The Trustee, however, suggests several alternative reasons to permit the shareholders a 7-½% interest in the reorganized company:

1. Because of potential fraud claims by shareholders against

the corporation, their participation should be permitted as a form of compromise of their claims as creditors.

2. The compromise of the claims of senior creditors included an understanding of all parties, including the debenture holders, that the shareholders would have a substantial interest in the reorganized corporation in return for giving up equitable subordination claims against the senior creditors.

The debtor supports these views and adds the following reason for stockholder participation:

Since the senior creditors received only 84% of their principal claims, it would be a violation of the principle of absolute priority to permit the deb-

enture holders to receive a greater percentage of their claims. The shareholder would be entitled to the remainder of the estate.

I reject all of these theories. For the court to elevate the rights of shareholders as a part of a compromise of claims there have to be viable claims to compromise. Some shareholders may indeed have once had a claim against the estate for fraudulent representations which induced them to buy their shares. Several shareholders' class actions against CMI were, in fact, filed. No claims have been filed in these proceedings, however, and the time for filing is past. As a result, the class actions are dead and the shareholders' claims are no longer viable. The Trustee suggests that I could extend the time for filing, which is within the court's discretion. To revive a claim so that I can

compromise it, however, strikes me as bald manipulation rather than creative use of the court's equitable power.

The compromise agreement with the senior creditors which I approved contained no assurance to the shareholders that they would participate in the eventual reorganization. As I viewed, and view, that arrangement, what the shareholders bargained for was a chance to participate, which they would not have had if the senior creditors had been successful in maintaining their claims in full.

The debtors' theory in untenable. The senior creditors waived their priority claims in order to obtain a relatively fast bailout. Their percentage of recovery has no bearing on the remaining aspects of the reorganization.

Accordingly, the shareholders will participate in this reorganization only to the extent that the reorganization value of

the estate exceeds the claims of creditors. The shareholders have some equitable claim for consideration, but that claim is amply satisfied by holding post-petition interest on the debentures to pre-default rates rather than the stepped-up post-default rates provided by the terms of the debentures, and by disallowing interest on interest.

E. The NOL.

Critical both to valuation for reorganization purposes and the feasibility of the Trustee's plan is the viability of the NOL. The Trustee's certified public accountant has testified that there is a cumulative NOL of approximately $140 million which can be fully utilized to shelter substantial income of the reorganized company from federal income tax. The NOL is available because of special tax provisions governing REITs which permit the

carry-forward of loss from certain years 15 years into the future. The NOL is subject to audit when used. If the Internal Revenue Service conducts future audits, the reorganized company will have the burden of showing that the losses occurred in the qualifying years and that CMI qualified as a REIT during those years.

While the Trustee's witness testified that the record support for these positions will be available, Mortimer Caplin, a former Commissioner of Internal Revenue, testified that in his opinion the conduct of CMI management from 1972 through 1976 as revealed in the Trustee's own §167 Preliminary and Partial Report might result in the disqualification of a substantial part of the NOL.

It is impossible to quantify these doubts in terms of valuation, and Mr. Caplin's testimony offers no clue. I will not make any attempt to resolve the validity of

the NOL for several obvious reasons:

1. The principal adversary, the Internal Revenue Service, is not a party to these proceedings;
2. The relevant evidence has not been developed before me; and
3. This is not the forum in which the issues will be decided.

The Trustee's valuation witness suggests that the potential weakness of the NOL should be reflected by discounting future cash flow at a high rate appropriate for an increased risk. I do not find this a wholly satisfactory measure of a risk running somewhere between 0 and $140 million. Neither Committee B nor anyone else has offered any better solution, however. Committee B's suggestion that the NOL be treated as of no value has no more virtue

than the suggestion that it be treated at full value.

Accordingly, for purposes of assigning a reorganization value to the estate, I shall adopt the Trustee's suggestion of projecting future cash flow as if the NOL could be fully utilized and adopting a discount rate which presumably reflects the risk that the NOL will be to some extent disallowed.

F. Valuation.

Assuming the viability of the NOL, valuation of the proposed reorganized company is still dependent upon a number of other variables: appreciation in the value of the Ridge over the expected period of liquidation; the absorption rate (the time it will take to sell off the Ridge); the expected rate of return on reinvested proceeds of sale; and the discount rate applied to reduce the expected future cash

flow to present value. Wide ranges of choice of each of these variables are rationally supportable. Selection of particular values within those ranges must be frankly recognized as reflecting subjective evaluation. Accepting the basic postulates of the John Child appraisal of the Ridge, I have decided to apply a 15% straight line rate of appreciation, a 17% rate of return on reinvestment and an 18% discount rate. The result is a reorganization value of approximately $67.8 million.

The present liquidation value is approximately $53.8 million.

G. General Considerations.

The reorganization proposed by the Trustee is not the typical reorganization which would be proposed for a manufacturing company, a utility or a railroad, in which the reorganized company would carry on some part of the old company's former business

with a new capital structure. This company has but one noncash capital asset, Hawaii Loa Ridge, and its aim is to sell it. The choice is between immediate liquidation and gradual liquidation through the development and sale of lots.

The Trustee's plan has the following characteristics:

A. On the positive side, there is the potential utilization of the NOL to derive an entrepreneur's profit from the development of the Ridge sheltered from income tax. The capital which then might be reinvested in a new business would be formidable, enabling a wide variety of choices and providing financial strength to the new enterprise. The reorganization value which I have assigned would permit some participation by the shareholders.

B. On the negative side, the ultimate business of the enterprise is unknown, and the course of future investment will be set not by the investors but by the board of directors of the reorganized company. If the NOL is disallowed to a substantial degree, furthermore, the advantages of the plan will evaporate.

The plan proposed by Committee B has the following characteristics:

A. On the positive side, immediate realization of cash for the debenture holders and the exercise by them of their own choice of reinvestment.

B. On the negative side, the chance to realize the value of the NOL would be irrevocably abandoned. Shareholders would not participate in any respect.

H. The Possibility of Submitting Both Plans to a Vote of Creditors.

I find no clear rational criteria for choosing between these plans. The bias in Chapter X proceedings in favor of reorganization fades when the choice is in effect between two forms of liquidation and reinvestment, although a bias doubtless remains in favor of a plan which offers some return to the shareholders. Basically, the choice would be governed by one's predilection for long-term open-ended adventure with the possibility of large profits as opposed to a predilection for a quick return. For debenture holders who purchased their securities post-petition at sharply discounted prices, a return at slightly over par may be attractive.

One way to offer the investors a choice would be to submit both plans to a vote. While the Bankruptcy Act permits this course, virtually all courts and com-

mentators have rejected it as confusing to the security holders and likely to result in rejection of both plans. I agree, and reject that option.

I. Findings.

In my opinion, nevertheless, there should be some element of individual choice available beyond the two-thirds voting requirement mandated by the Bankruptcy Act. If the Trustee's plan were to receive the required number of favorable votes, the dissenters would become involuntary participants in an unidentified endeavor. While it is possible that the increased financial power of the reorganized company will be reflected in the price of its common stock, this is not necessarily so while a cloud remains over the NOL. "Opting out" through the marketplace may not be the viable choice which Mr. Eisenberg suggested in his testimony.

I find that Committee B's plan is not fair and equitable because it forecloses any chance of utilization of the NOL, a potentially valuable asset of the estate.

I find that the Trustee's plan is not fair and equitable because it provides no mechanism for a dissenting debenture holder to be released from a form of open-ended investment which he never contemplated and which no one can presently confidently evaluate for the long term.

J. Substitute Plan.

All parties shall have the opportunity to file proposed substitute plans within thirty days. Without imposing any limitation or requirements on the parties, I offer the following suggestions as to acceptable provisions:

1. A plan like the Trustee's plan, with the shareholders' share calculated on the basis of

the excess of the value which I have placed on the estate over debts, post-petition interest to be limited to the pre-default rate, without interest on interest.

2. A provision for dissident debenture holders to signify a desire to liquidate their securities within sixty days of the confirmation order. The reorganized company would then pay the principal value of their notes[2] to such former debenture holders in cash within six months of such notification, plus interest at the pre-default rate from the date of the confirmation order. If the number of liqui-

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[2] They should be entitled to no more than under present liquidation as proposed by Committee B.

dating former debenture holders was so large that such payment drew available cash below acceptable levels, the new management would be forced to decide either to liquidate or to raise the cash some other way. The forces of the marketplace will control, which in the peculiar circumstances of this situation is, in my opinion, an acceptable solution.

K. Committee B's Motion - Proposal of Spartan Manufacturing Corporation.

Committee B's motion to require the Trustee to accept the offer of Nu-West to purchase the Ridge is DENIED. Such denial shall not be deemed a limitation on the Trustee's freedom to explore offers of sale and to file a plan based thereon. In particular, I commend to the Trustee's atten-

tion exploration of the proposal described in a letter to me from Spartan Manufacturing Corporation ("Spartan"), dated December 16, 1981, a copy of which is annexed hereto. I invite Spartan to submit a plan and order that the name of Lawrence M. Powers, the chairman of Spartan's Board be added to the notice list. The Spartan offer in its present form presents some considerable difficulties, based as it is on the John Hancock Plan. The component of Spartan stock may be inadequate. The opportunity for creative negotiation is clearly present, however, and in my opinion should be pursued. It should not be pursued, however, without knowledge of a letter received today from counsel for Nu-West, a copy of which is also attached.

/s/ Walter Jay Skinner
United States District Judge

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

| | | |
|---|---|---|
| In Re | * | In Proceedings |
| CONTINENTAL MORTGAGE | * | for the |
| INVESTORS, | * | Reorganization |
| | * | of a Corpora- |
| Debtor | * | tion |
| | * | No. 76-593-S |

MEMORANDUM AND ORDER ON
REVISED REORGANIZATION PLANS

July 15, 1982

SKINNER, D.J.

Hearings on the approval of a reorganization plan for Continental Mortgage Investors ("CMI") commenced on October 5, 1981, and continued for seven hearing days through October 16, 1981.

Following the October plan hearings, the court on December 18, 1981, entered an order ("the Order") finding the reorganization value of CMI, finding two of the re-

organization plans before it not "worthy of consideration", and denying its approval to the other two filed plans. Order at 3-4, 7, 10. The parties were invited to submit substitute plans and the court made certain suggestions for plan provisions. Order at 10-11.

Further plans were submitted by the reorganization Trustee and Debenture-holders' Committee B and a plan was submitted by Spartan Manufacturing Corporation ("Spartan").

Continued hearings were held on the plans on April 5, 7, 22 and 23, 1982. Among the witnesses were experts in investment banking, Tr. 3 to 62, 3-172 to 3-213, 3-214 to 3-238, 4-15 to 4-69, 4-154 to 4-156. The court also heard personal testimony from persons with a financial stake in the outcome of these proceedings. Tr. 4-73 to 4-145; Tr. 4-158 to 4-190.

Evidence was introduced to support the

Trustee's plan and that of Spartan. Committee B presented no evidence in support of its own plans but stated that it might support the Spartan plan if Spartan could secure the necessary financing and if their investment bankers indicated that the Spartan plan were feasible. Tr. 21. On the last day of the hearing, Committee B stated that it was "still of an open mind" regarding the Spartan plan. Tr. 4-71.

The reorganization and liquidation values of CMI were determined in my Order of December 18, 1981. Clearly such valuations fluctuate with market conditions, but in a continuing proceeding, considerations of time forbid a rehearing on valuation at each step. I assume the valuations of December, 1981, to be still valid within a reasonable range of error, despite the current depression in real estate sales. Sales on Hawaii Loa Ridge ("the Ridge") have continued through the

spring of 1982, though at less than the projected rate.

Committee B's Plan

Committee B's substitute plan bears a superficial resemblance to my suggestion contained in the Order.[1] Debentureholders are afforded an option of taking cash in the amount of 105% of the amount of their principal claims or stock in a reorganized CMI. The "New Trustees" of the reorganized company, however, would then be obliged to effect a sale of the entire Ridge as soon as practicable. In effect, this plan effects liquidation, which Committee B has been promoting throughout most of this case. The prospect of the proposed new

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[1] There was expert testimony during the April hearing that my suggestion could not be effectuated in the present market without triggering a run on CMI's cash that would leave the resulting company unable to survive. I accept this testimony as being accurate and withdraw my suggestion.

corporation is for a short, bleak and unprofitable life. Any prudent debentureholder would take the cash option. Since 105% of the principal amount of the debentures far exceeds CMI's available cash, a distress sale of the Ridge would be required. For reasons stated in the Order, I do not consider this plan any more fair and equitable than Committee B's previous plan.

Spartan's Plan

The new entry is the plan offered by Spartan. Spartan's plan calls for the creation of a holding company of which each of Spartan Manufacturing Corporation and CMI is to be a subsidiary. Spartan Plan at 1. Distributions of securities under the plan are to be in securities of the holding company. Id. The plan provides that each creditor's claim will be satisfied by the issuance of stock and warrants and that a creditor may then choose to surrender the

stock and warrants it receives for a pro-rata share of a $27 million cash fund plus, if surrendered securities exceed a certain level, a pro-rata share of 51% of the outstanding stock. Id. at 15-16. If surrendered securities stay below the threshold, each surrendering creditor will receive $1,050 cash in respect of each $1,000 principal of his claim (and nothing in respect of his interest claim, if any). Id. Shareholders' interests will be satisfied by the issuance of stock constituting 2% of the outstanding stock (if the debenture-holder-surrender threshold is exceeded) or 4% thereof (if the threshold is not exceeded). Id. at 17.

Spartan's management refers to it as a "highly leveraged" company. In plain language, its assets exceed its debts by a very thin margin. Its 1981 debt/equity ratio was 8.4 to 1. Its debt service charges are currently $6 million a year.

Over $50 million in debt is scheduled to mature before fiscal 1987. While its lines of credit have been renewed regularly up to now, failure of continuing renewal would put the company under. After payment of mandatory preferred stock dividends, Spartan shows no earnings applicable to common stock. The market price of its common stock has dropped from $3.50 per share in October, 1981 to $1.25 per share in April, 1982. The aggregate market value of Spartan stock is only two-thirds of the value of the cash which CMI would bring to the venture. CMI security holders would own 55% of the combined corporation, but it would be managed by the Spartan board of directors, who enjoy an entrenched position under a Spartan by-law which would be carried over to the new company.

Spartan proposes to finance the cash pay-out to CMI debentureholders and provide for working capital as follows:

$7 million of CMI's cash,

$5 million of Spartan cash,

$30 million loan from a financial institution.

The entire plan is dependent upon securing the $30 million loan. The First National Bank of Boston has agreed to provide financing in the initial amount of $20 million on the following terms, inter alia:

(a) The first Hawaiian Bank must agree to a $10 million participation;

(b) The interest rate will be prime plus 2%;

(c) The bank will be paid an annual management fee of $200,000 regardless of the amount outstanding on the loan;

(d) The bank will share in the gross proceeds of lot sales, whether or not the loan has been repaid, in shares ranging up to 16% of gross sales proceeds and a maximum of $15,000,000, with a minimum annual payment of $500,000 even if no lots are sold;

(e) The loan will be secured by a first mortgage on Hawaii Loa Ridge and a pledge of all accounts receivable from lot sales;

(f) A bank-approved joint venture partner will be expected to contribute $500,000 and will receive 5% of gross sales. FNBB May Letter at 1-3.

The initial amount of the loan is a maximum of $20 million, with a "possibility of the loan rising to $30,000,000 depending on the valuation and availability of collateral".

Spartan believes that it is doubtful that either of the persons being considered as a joint venture partner would be willing to make a substantial cash investment in the venture. Tr. 3-78.

I find that the Spartan plan is neither fair nor equitable in that the outstanding debts of Spartan plus the proposed additional financing will leave CMI security holders with, in the most likely case, the prospect of another bankruptcy and, at best, the expectation of sharing in the hole after The First National Bank of Boston has eaten most of the doughnut. In

fact, given the conditional nature of the bank's commitment, it is doubtful if the plan is even feasible.

Trustee's Plan

The Trustee's substitute plan is basically the same as its original plan, making an adjustment in stockholders' shares in the reorganized company to reflect the reorganization valuation contained in the Order.

My previous objection to the Trustee's plan, as stated in the Order, was the fact that investors were locked into a future investment of an uncertain nature without a financially viable escape. I was skeptical of Mr. Eisenberg's opinion that the reorganized company's build-up of assets would be reflected in the market price of

stock.[2] That opinion has received persuasive inferential support in the new hearings in the testimony by Mr. Rosenthal, a speculator in "deep discount" bonds. ("We don't call it junk any more." T. 4-103, 104).

It is unnecessary for me to decide if there will be sufficient protection in the marketplace for the shareholders in the reorganized company, however, since the Trustee's plan does not pass muster under a recent decision of our Court of Appeals. In Debentureholders Protective Committee of C.I.C. v. C.I.C., _____ F.2d _____ (1st Cir., April 30, 1982), the Court held

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2 One additional new fact that emerged in the 1982 hearings was that all of the debentureholders who have been represented in this case bought their debentures at a small fraction of par. The most vociferous opponent of the Trustee's plan could recover his investment four or five times at the present market. While this has no legal significance, it does affect the weight I will give to his testimony.

that in a case in pertinent respects on all fours with this one, the debentureholders are entitled to interest on unpaid post-petition interest as a matter of federal law. This is true even though the state law governing the rights of debentureholders (New York, in both cases) prohibits interest on interest. The state law was held to bar interest on pre-petition interest but not interest on post-petition interest. The court left open the question whether debentureholders could be required to accept a financially equivalent substitute, but held that mere acceleration of the time of payment was no more than the debentureholders were due under the terms of their debenture and was not a financially equivalent substitute in any case.

In addition to interest on post-petition interest, the C.I.C. opinion states flatly that interest on post-petition instalments of principal is to be allowed at

the general legal rate of 8% rather than the contract rate. Presumably, it is still an open question as to whether a financially equivalent substitute may also be forced upon the debentureholders in lieu of this augmented interest. The Trustee argues that the rate of interest on instalments of principal was not at issue in C.I.C. (wherein he also served as Trustee) so that the Court's statement is dictum, and at variance with decisions in other circuits. I find the Court's conclusion surprising, but there it stands in black and white as a statement of the law of this Circuit, dictum or not, and I cannot ignore it. There may indeed be some justice in giving the holders of defaulted notes at least as good interest as other general unsecured creditors.

The Trustee and Committee B calculate the results of these strictures somewhat differently. The difference is unimportant

because in either case the debentureholders will share the entire estate and the shareholders will be excluded, since the debentureholders' claims exceed the reorganization value of CMI.

In an effort to preserve something for the shareholders notwithstanding the foregoing, the Trustee and the debtor repeat in effect the arguments made in behalf of shareholders in the first hearing, which I discussed at some length in the Order. They now concentrate on the rights the shareholders gave up to effect the Compromise with Senior Creditors, which in turn they say has increased the debentureholders' participation in the estate. Thus, according to the argument, the shareholders gave up something which permitted the debentureholders to do better in the reorganization than they otherwise would have done, and accordingly the debentureholders have already received the financial equiva-

lent of interest on interest and interest at 8%.

One of the reasons for the Compromise, however, was the uncertainty of various claims against the Senior Creditors. As to what would have been the reorganization value of all of the assets of CMI as they existed before the Compromise, one can only speculate. Even accepting the very doubtful proposition that a benefit received other than as a part of the reorganization plan itself can be accounted the financially equivalent substitute for interest on interest, I am unable to quantify the benefits accruing to the debentureholders from the Compromise with sufficient certainty to say that there is in fact financial equivalence.

Counsel for the debtor and for the Trustee correctly point out that in refusing interest on interest in the Order I recognized equities in favor of the share-

holders. I am persuaded that the circumstances of the Compromise, the participation therein of debtor's counsel and the reasonable expectations of all of the parties at that time created some equities in favor of shareholders. Under the C.I.C. opinion, however, perceived but inchoate equities are of no account in the face of a flat rule of law: debentureholders are entitled to interest on post-petition interest or to a financially equivalent substitute.

The net result of all of this is that the Trustee's plan must be rejected as not fair and equitable because it provides for shareholder participation without either allowing debentureholders their statutory 8% interest on post-petition instalments of principal and interest on post-petition interest or providing financially equivalent substitutes.

Accordingly, I shall further continue the plan hearing until September 20, 1982

to give the Trustee a chance to submit a further amended plan which conforms to the strictures imposed by the Court of Appeals in C.I.C.

So ordered.

/s/ Walter Jay Skinner
United States District Judge

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